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DOW THEORY LETTERS INC.

"The Market as Interpreted under the Dow Theory"

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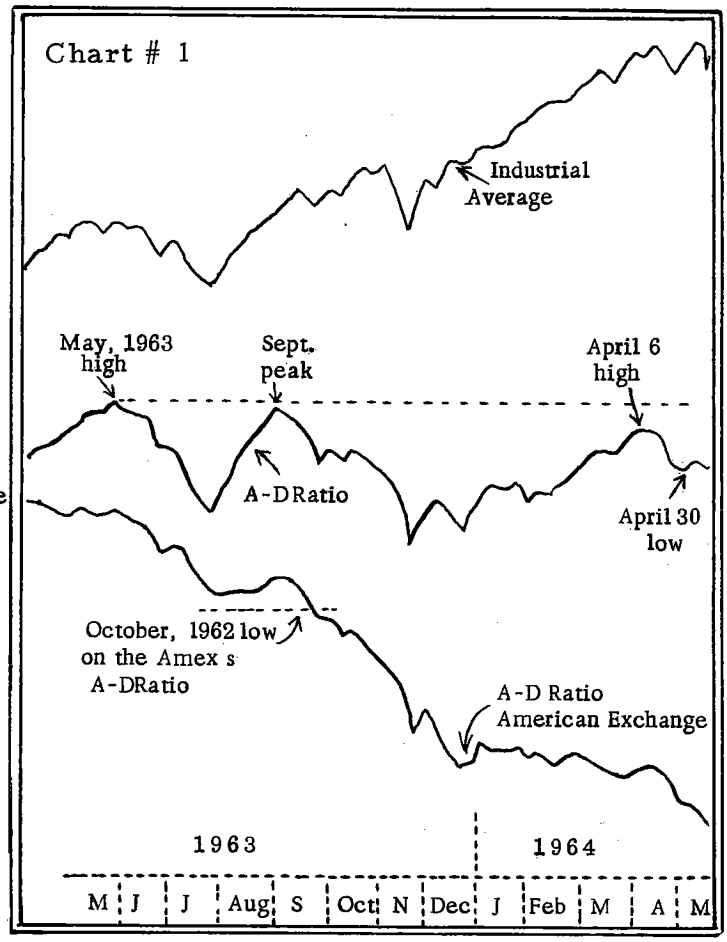
THE MARKET: On Wall Street things are seldom what they seem. The reason for this is that the market is concerned only with the future; it is never interested in the past, and it is seldom interested in the present. The only time the market bothers itself about the present is during one of those rare instances when the unexpected suddenly materializes. When a true surprise does appear, the result may be a sudden burst of bullishness such as the explosion which occurred during 1933 when the price of gold was raised — or a panic decline such as the one which occurred in 1955 on the news of the "Eisenhower heart attack." But apart from the dramatic and unexpected, the market generally takes little notice of the things which most people "expect" it to notice.

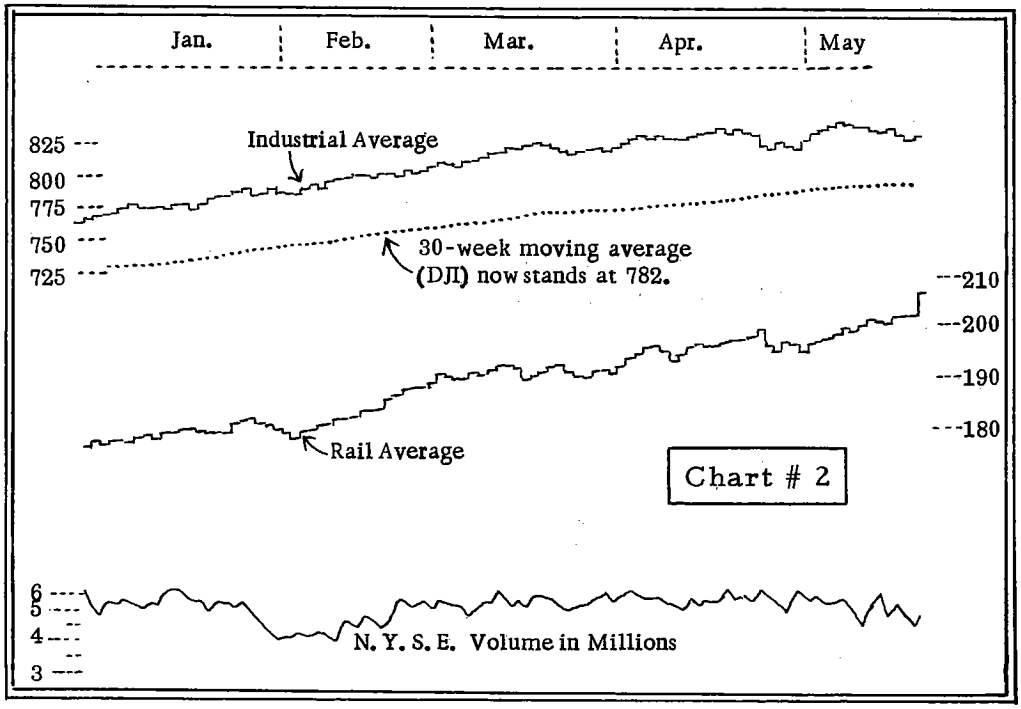
The first quarter high for the Industrial Average was recorded on March 18 at 820.25. Since then there has been a virtual avalanche of bullish news — record auto sales, record personal income, record construction activity, record heights for the F.R.B. Production Index. Despite this rosy "history" (and all facts are history) and despite the greatest April stock market volume in history, the Industrial Average has been unable to push as much as 2% beyond its (March 18) first quarter peak.

According to Dow's Theory, the movements of one Average unconfirmed by the other are useless for predictive purposes, and more often than not are deceptive. On May 7 the Industrial Average touched an all-time high of 830.17. Industrials immediately turned down, but the Rail Average continued to rally — establishing all-time highs on May 19 and 20. Thus the two Averages have entered into a period of acute divergence (Chart 2). This "parting of the ways" is usually indicative of "internal tension" within the market, and the movement following a protracted divergence can be violent. It will therefore be interesting to see whether the stronger Rail Average elects to follow the Industrials down — or whether the Industrials decide to follow the bullish lead of the Rails.

* * * *

Letter 253 contained a detailed description of the current critical breadth-price relationship. Following the series of three new Industrial highs against the series of three declining peaks in the A-D ratio, it was stated that the last low (i.e., the April 30 low) on the A-D ratio constituted the danger level. A break below the April 30 low by the





 breadth index (see Chart 1) would be an important "sell signal."

On May 19 the A-D ratio, as seen on the chart, came within 215 net declines of breaking the April 30 low. However, the market rallied on May 20, with the result that the breadth index is still fluctuating between the April high and low. The final penetration of the A-D ratio above the April 6 high or under the April 30 low will be an extremely important technical indication for the market. But until such a resolution of breadth does occur, the only certain conclusion is that the market will continue to be a perplexing and profitless affair.

COMMENTS: In the last Letter I discussed the odds for stock market profits and losses in terms of the trend of the majority of stocks (i.e., the advance-decline ratio). After many years of personal (often costly) experience, I have concluded that there are two prerequisites for making money in the market: (1) The investor should be in the market only when the primary trend is clearly bullish and when the majority of issues are in an advancing trend. (2) Assuming the majority of stocks to be rising, the investor should be only in those stocks which are behaving better than the general market (i.e., stocks which have rising relative strength lines). Conversely, if the investor owns stocks which are not acting as well as the market or if he is in the market when the majority of issues are moving sideways or down, his chances of making money (considering brokerage commissions, bid-and-asked differential and taxes) are considerably less than 50/50.

During a normal bull swing, the Averages and the majority of stocks are in a rising trend. There have been times such as 1942 to 1946 when the majority of stocks far outpaced the Averages. There have been other times such as 1954 to 1956 when the Averages outperformed the majority of stocks. But in general, the most profitable movements have occurred when the A-D ratio and the Averages are registering successive new highs together.

Referring to Chart # 3, during the period of 1949 to 1953 there were 45 months during which the A-D ratio and the Averages were "in gear" on the upside. Except for the phenomenal 49 month rise between 1942 and 1946, this was the most profitable period of rising breadth in modern history. During 1953 to 1956, breadth and the Averages continued higher for 31 months, and this two was an extremely profitable period. The 1957-59 rise saw breadth and the Averages rise for 15 months, a span which saw many spectacular rises in many stocks. The 1960-61 rise lasted only 7 months as far as harmonious breadth-price performance was concerned.

Finally, the advance which began in October, 1962, matched 1960-61 in that it too produced only 7 months of rising breadth against a much greater rise in the Averages.

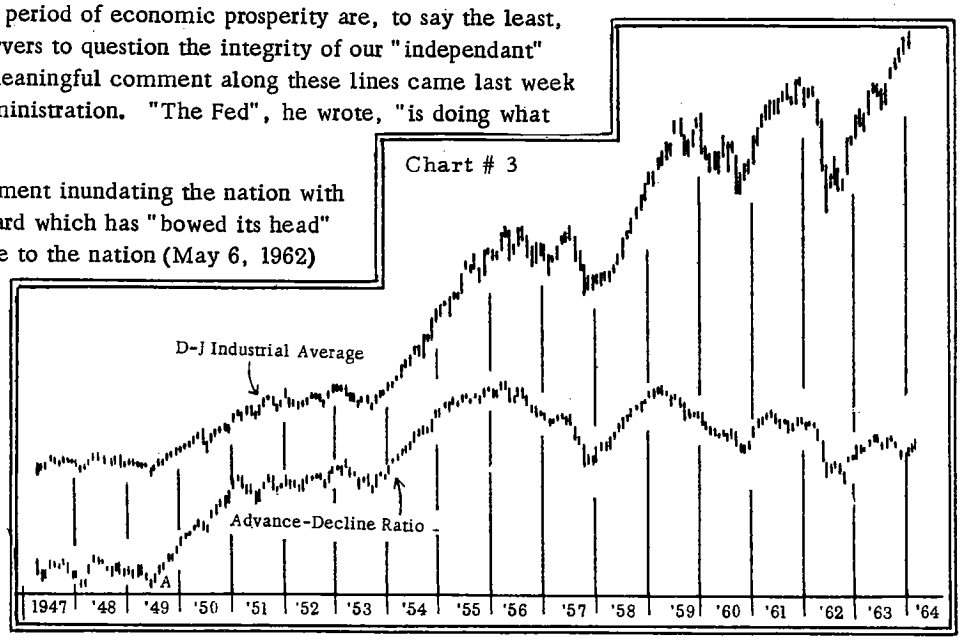
It is a remarkable fact that a full year has now passed since the last (May, 1963) peak in the A-D ratio. Despite this, the Averages are still in the vicinity of their all-time highs. The spectacle of the Averages continuing to rise a year beyond the peak in breadth is one that has never been seen before in the stock market. And as if to add emphasis to this performance, we are now seeing the Industrial Average near its high a full 7 months after the last peak in General Motors. This too, is a "first" for the N.Y.S.E. record book. Add to this the fact that the yield on the Industrial Average has been in the 3-4% zone since late 1958 and you get a strange and unprecedented picture. All of which brings us to the following series of questions:

Is the primary trend still bullish? This is a question which I have asked myself over and over again. My answer is "yes", but it is awfully tired. I believe that "classic" economics and an orthodox supply-demand equation would probably have produced a severe but not disastrous primary bear market in 1957. But huge infusions of Government credit via the Federal Reserve ("monetization" of the debt) succeeded in pumping up the economy again. In 1959-60 another recession struck, and again the Government stepped in. The recovery lasted until 1961, but during the following year (1962) the stock market crashed. A collossal new round of debt monetization began, one which has continued unabated to the present.

The current net free (bank) reserves during a period of economic prosperity are, to say the least, rather unorthodox, and it has led many observers to question the integrity of our "independant" Federal Reserve Board. Probably the most meaningful comment along these lines came last week from a friend who is close to the Johnson administration. "The Fed", he wrote, "is doing what it is told!"

So we have the picture of a powerful Government inundating the nation with money and credit, and a Federal Reserve Board which has "bowed its head" while its Chairman goes so far as to announce to the nation (May 6, 1962) that demand for credit is "far below anything I anticipated" and therefore interest rates will not be expected to rise. Finally, we now have a President who is doing everything possible to "talk" the country into a pre-election boom, a President who can tell the Advertising Council that "times are good", and at the same time ask for a huge "Anti-Poverty program."

Chart # 3



All of this has had the effect of extending the primary bull trend. But the frequent "inflation hypos" have left their mark on the patient. It has been estimated that 70% of the stocks on the N. Y. S. E. are now below their 1956-62 peaks. Furthermore, approximately 25% of the stocks on the Big Board and about half the stocks on the AMEX are in a state of collapse. Meanwhile, the nation's largest and highest quality corporations have been the ones which have been best able to withstand the ravages of inflation, heightened foreign and domestic competition and general inefficiencies caused by years of "easy living". These large corporations are the ones which are represented in the Averages. The current financial schizophrenia has caused many analysts to fall back on that hoariest of hedges, "It's a market of stocks", rather than to attempt any further intelligent analysis of the overall trend.

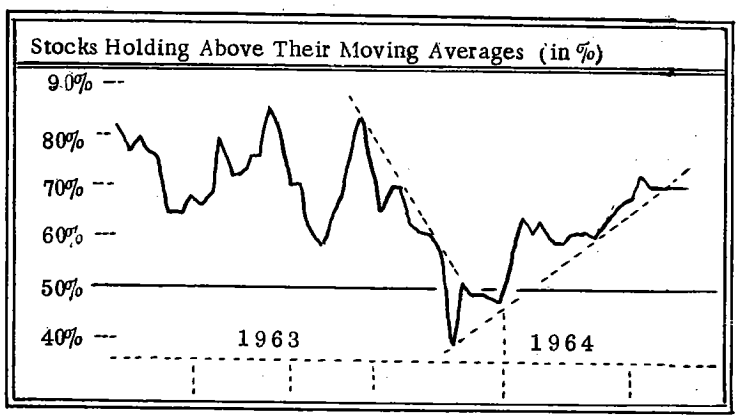
According to classic Dow Theory, as long as the Industrial and Rail Averages push to successive new highs the primary trend must be considered bullish. The fact that a bull market is considered still to be in effect has prompted the heartiest of the bulls (and their argument is not without merit) to insist that this market will end in the same way that the other great bull market of the twentieth century (1921-29) ended — with a final "blow-off".

But will the blow-off materialize? This is the question which has intrigued investors and traders for over five years. My only answer is that if a blow-off is to appear, I see no sign of it yet. One of the surest indications of a possible market "explosion" has always been a significant rise in breadth on that most speculative of U. S. exchanges, the American Exchange. It is hard to conceive of the market becoming excited without some signs of that excitement quickly appearing on the "junior board".

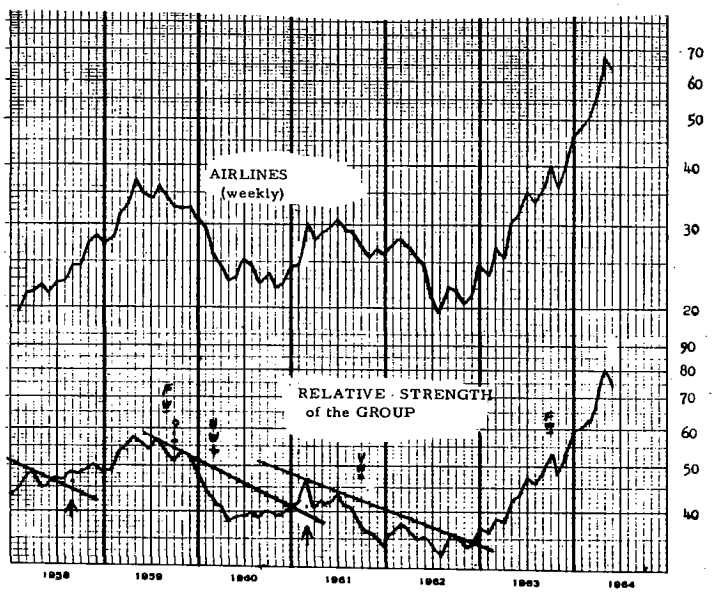
For example, my record of the A-D ratio on the Amex (going back to 1932) shows a sharp rise in breadth during most of 1936 and the first two months of 1937. It shows an almost perpendicular rise in Amex breadth during all of 1945 and the first half of 1946. There was a good rise during 1958 and the first quarter of 1959. A violent climb in Amex breadth occurred during the first five months of 1961, and a four-month rally took place during November-December, 1962 and January-February, 1963.

CONCLUSION: Not all rises in Amex breadth have been the harbingers of speculative blow-offs, but all blow-offs in the New York market have been accompanied by rising Amex breadth. As this is written, the A-D ratio on the Amex is at a new low — far under the 1962 crash low (chart 1, page 1). The breadth on the Amex may start rising "tomorrow", but as of now there is no hint of speculative interest on this exchange.

STOCKS: Of 432 representative stocks which are tabulated here weekly, 310 (70%) are now holding above their 200-day moving average — no change from last week. As long as the percentage holds above 50% the study remains bullish.

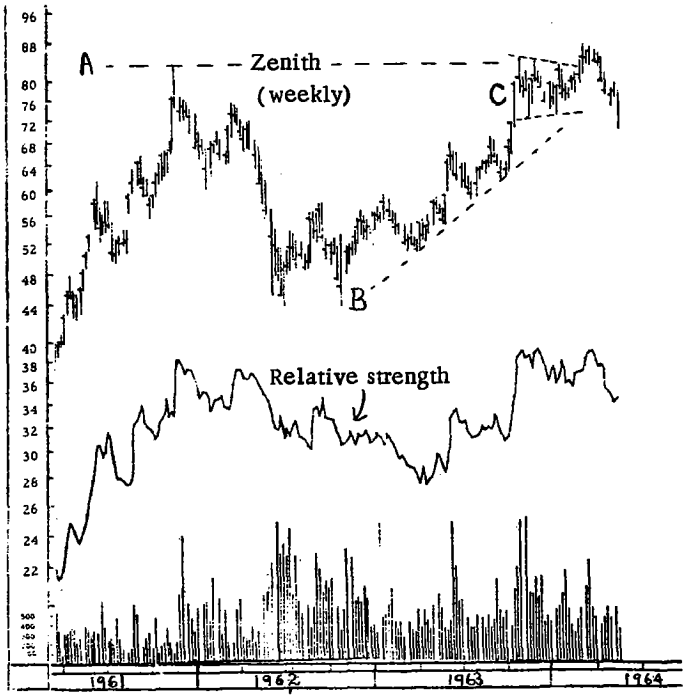


Letter 253 contained comments about the three leading automobile stocks, a group which might be termed the "economic leaders" of 1962-64. The "speculative market leaders" of the 1962-64 period have undoubtedly been the Airlines. The accompanying chart traces the monthly price and relative strength (R. S.) of the Airline group since 1958. This chart is from Ray * Signals (141 Broadway, New York City) and that organization's latest comments regarding the Airline group's performance is most informative. They note that a "breakway signal" is a rise of 12% or more in a group's R. S. ratio during any given month, and an "adjustment signal" is a drop of 5% or more during a subsequent month. This sequence (see chart) occurred in the Airline group during March and April of this year. It is of interest that the Airlines last performed in this way during 1945-46, at which time the group "topped out." Ray * Signals notes that the breakaway and adjustment type of action is usually followed by a poorer-than-the-market performance for some months, and it "also carries the possibility of such a development on a long term basis." Conclusion: the Airlines have placed themselves in a weak technical position and should be avoided from here on.



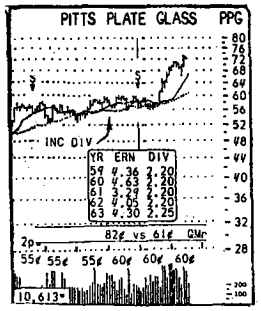
Back in Letter 257 I drew attention to the large symmetrical triangle in Zenith, a quality stock which has (in the past) been very reliable from the technical standpoint. The action in ZE since Letter 257 has been so typical of a good deal of the action in the market that it is worth analyzing. Note on the weekly

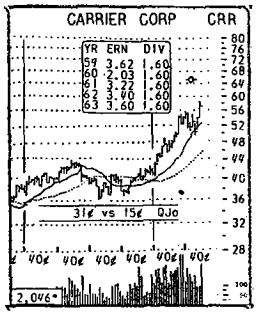
chart that ZE formed the large triangle at C, and that the "breakout" took the stock to a new all-time high above the 1961 top. But the breakout proved to be a "technical trap", and after pushing above the previous high (at A), ZE promptly rolled over and fell away. As of last week ZE had penetrated the major ascending trendline (B) which has contained all temporary corrections since late 1962. We now know that the "big 1964 breakout" in ZE was a false move, and the stock has probably seen its high for a long time to come. The obvious "selling signal" was the breaking of trendline B.

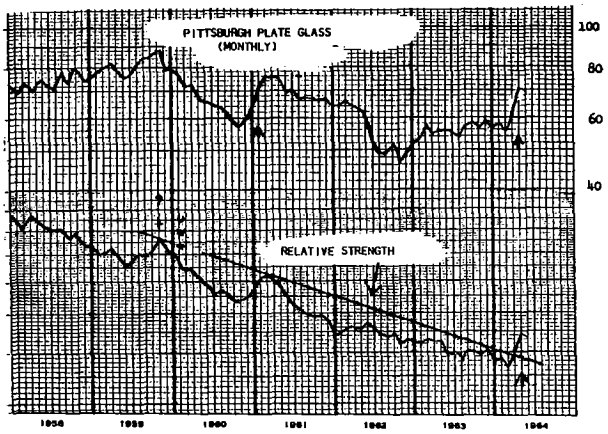


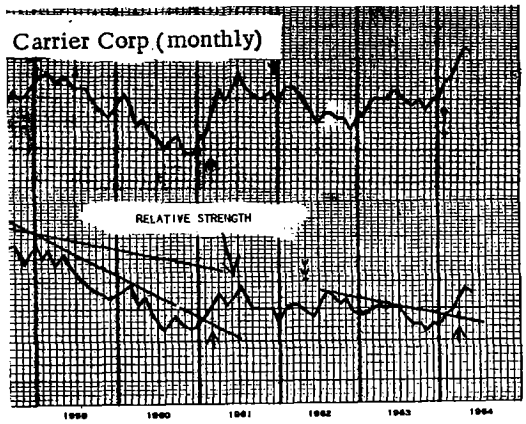
This type of "distribution on a breakout" has now become so common that serious students are wondering if there are not too many technically inclined buyers in the market. Recent false breakouts occurred in Gillette, U. S. Steel, Parke Davis, Carter Products, National Cash Reg., and SCM. It will be particularly interesting to watch Baldwin-Lima which just broke out of a two-year rectangle when it touched 15. Watch Chrysler after its 51 1/2 breakout, and watch GM and Ford for potential multiple tops. One of the signs of a strong market (one which is in the hands of professionals) is a series of valid breakouts. In such cases, stocks purchased at or near the breakout points continue to rise and seldom give the buyer a bad moment. Conversely, a series of obviously false breakouts (particularly in leading stocks) suggests distribution. Here, sellers are willing to hand the shares out as fast as the "technically oriented"buyers are willing to buy. This is what happened in Zenith; it is too early to know whether it has occurred in GM and Chrysler.

Going through dozens of group charts and hundreds of individual charts, it is now no easy job to come up with "hopeful" speculations. The Heating and Plumbing division of the Building Group has just turned up after a four-and-one-half year trend of declining R. S. Within this group, two stocks look particularly interesting — Carrier Corp. and Pittsburgh Plate Glass. Carrier (refer to larger monthly chart) has pushed above a five-year trend of declining R. S. The odds are that CRR will outperform any kind of market over the months ahead. The small weekly chart shows CRR gathering volume as it touches its 200-day moving average and then pushes up to a new high for the year.









Pittsburgh Plate has reversed a six-year decline in R. S. (see monthly chart), and the smaller weekly chart shows PPG breaking out of a long "line"-type structure which lasted from early 1963 to March of 1964. PPG and CRR are two of the most attractive situations on the N. Y. S. E.

Elgin (discussed in recent Letters) has faded but is still within its large ascending triangle. Would not "throw in the sponge" on this one unless it broke below the lower trendline of the triangle (200-day moving average on ENW is 11).

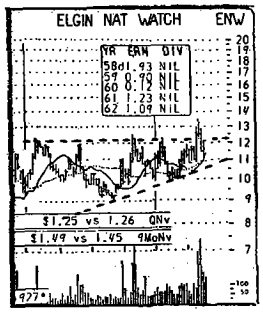


Chart of ZE courtesy of Traders Research, 1431 Pearl Avenue, Alton, Ill. Charts of Airline group and larger monthly charts of PPG and CRR courtesy of Ray * Signals, 141 Broadway, New York City 6, New York. Smaller weekly charts of PPG, CRR and ENW courtesy of Quote Digest, 110 North Lorraine, Wichita, Kansas.